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## **Mandatory Disclosure of Blockholders and Related Party Transactions**

McCahery, J.A.; Vermeulen, E.P.M.

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# Discussion paper

## **MANDATORY DISCLOSURE OF BLOCKHOLDERS AND RELATED PARTY TRANSACTIONS: STRINGENT VERSUS FLEXIBLE RULES**

By  
Joseph A. McCahery, Erik P.M. Vermeulen

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# **Mandatory Disclosure of Blockholders and Related Party Transactions: Stringent versus Flexible Rules**

## **Abstract**

Investor confidence in financial markets depends in large part on the existence of an accurate disclosure and reporting regime that provides transparency in the beneficial ownership and control structures of publicly listed companies. Today, a common post-financial crisis regulatory reform theme is to tighten the disclosure and reporting rules that apply to large blockholders. We examine the implications of this trend, analyzing whether detailed, stringent and mandatory reporting rules could have a counterproductive effect on the financial markets. A central idea of this paper is the evolution of a well-balanced regime that is flexible and proportional and allows for a case-by-case determination of a beneficial owner. In the current era of information-based technology, the most obvious challenge for regulators is to design a legal framework that is adaptable to technological change and its impact on financial instruments.

**Keywords:** beneficial ownership, control enhancing mechanisms, corporate governance, disclosure, inside blockholders, outside blockholders, related party transactions, shareholders

**JEL Classifications:** G30, G32, K22, K42

# Mandatory Disclosure of Blockholders and Related Party Transactions: Stringent versus Flexible Rules

Joseph A. McCahery<sup>1</sup> and Erik P.M. Vermeulen<sup>2</sup>

## 1. Introduction

Corporate governance is important. An effective and sustainable corporate governance infrastructure helps promote investor confidence and assist firms in meeting investors' expectations. Yet in the aftermath of the financial crisis, policymakers and legislatures once again bemoan the absence of a corporate governance infrastructure that adequately protects minority investors and other stakeholders in listed companies.<sup>3</sup> There is often a lack of clear solutions for (potential) conflicts in listed companies caused by concentrated ownership and control structures. This is somewhat surprising since the concentrated ownership (or blockholder structure) is historically the predominant corporate governance system in the world. Of course, the accumulation of control in one or more shareholders may very well benefit minority investors by making management more accountable, thereby reducing managerial self-dealing problems.<sup>4</sup> However, controlling shareholders also have incentives to exploit corporate opportunities and engage in abusive related party transactions. The question thus arises whether a country's corporate governance infrastructure is sufficient to protect minority investors against the adverse effects of controlling shareholder opportunism.

Obviously, minority shareholder protection will be particularly challenging without the identity of the *de facto* or *de jure* controlling shareholder being available. In this respect, disclosure and reporting regulation is probably the most crucial measure to directly or indirectly detect and discipline opportunistic and abusive behaviour by controlling shareholders. In general, the disclosure of ownership is required by direct shareholders, including custodians, who accumulate shares beyond a certain threshold. However, under the current market conditions, it is fair to

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<sup>1</sup> Joseph A. McCahery is Professor of International Economic Law at Tilburg University, The Netherlands and Duisenberg School of Finance, Amsterdam, The Netherlands.

<sup>2</sup> Erik P.M. Vermeulen is Professor of Business Law at Tilburg University, The Netherlands and Vice President at the Corporate Legal Department of Philips in Amsterdam, The Netherlands.

<sup>3</sup> See OECD, Corporate Governance and the Financial Crisis: Key Findings and Main Messages, June 2009.

<sup>4</sup> See A. Shleifer and R.W. Vishny, A Survey of Corporate Governance, 52 The Journal of Finance 737 (1997).

say that the disclosure of significant direct shareholdings is not enough to adequately protect minority shareholders. Controlling investors have innumerable ways to hide their identity and/or enhance control by leveraging voting power, such as pyramid structures, cross-shareholdings, non-voting shares, derivative products of shares (i.e., depository receipts), and investor coalitions and agreements (i.e., acting in concert). It is therefore important that information about a company's ownership and control structures, including the identity of the ultimate beneficial owners,<sup>5</sup> is also revealed.

The purpose of this essay is threefold. Firstly, it critically analyzes the legal and regulatory regimes and practices governing the disclosure and reporting of ownership and control structures in listed companies. We attempt to assess to what extent and through which channels relevant ownership and control information should be disclosed and provided to the company and its investors, the market and supervisory authorities. Secondly, since related party transactions are the prime mechanisms for tunneling by controlling shareholders, we explore the beneficial effects of the disclosure rules designed to target related party transactions directly. Finally, we investigate to what extent the rules that intend to prevent the misuse of corporate vehicles may serve to overcome the difficulties in the regulation of conflicted transactions. Indeed, it is generally accepted that the problem of related party transactions is closely connected to the disclosure of beneficial ownership. It is therefore interesting to see whether the mandatory disclosure of beneficial ownership and control structures assists in revealing the preventing of self-interested related party transactions.

The essay is divided into six sections. The next section begins with a short discussion of the well-documented Enron and Parmalat scandals in order to explore the mechanisms employed by controlling shareholders to extract private benefits at the expense of minority shareholders and other stakeholders. Section 3 discusses the challenges policymakers and regulators face in their efforts to improve disclosure of beneficial ownership. Section 4 turns to assess the legal mechanisms designed to regulate related party transactions. Because the identity of beneficial owners is often concealed by the use of corporate vehicles, Section 5 considers to what extent that the rules designed to prevent the misuse of corporate vehicles could assist in obtaining on beneficial ownership and related party transactions. In the final

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<sup>5</sup> See OECD, Report on the Misuse of Corporate Vehicles for Illicit Purposes. This report defines "beneficial ownership" in terms of the ultimate beneficial ownership or interest by a natural person.

section we conclude that the functioning of financial markets depends on the introduction of a proportionate and flexible disclosure regime for market regulators to mitigate the negative impact of related party transactions by controlling shareholders.

## **2. The Enron and Parmalat Examples**

The high-profile corporate fallouts at the beginning of the century have underscored the need for regulators to work cooperatively to create timely and effective solutions to improve disclosure and corporate governance policies. Whereas corporate governance failures usually occur at the national level, there is no denying that the recent financial scandals at Enron and Parmalat involved questionable dealings (chains of corporate vehicles, improper swap arrangements and flaws in financial disclosure) that took on a global dimension. These scandals provoked a variety of responses and brought the issue of governance and accountability to the attention of lawmakers and the public.

In the Enron case, for example, the underlying problems were the prevalence of significant related party transactions involving high-ranking officers of the company. Since independent parties would not provide economic hedges for its merchant investments, Enron engaged in hedging transactions with related entities that in theory allowed Enron to accomplish its temporary accounting objectives of not reporting any decline in the value of the investments. Since the hedges lacked economic substance, the temporary accounting results were unsustainable and eventually required the reporting of significant losses that surprised the marketplace. These transactions not only furnished these officers with the possibility to enrich themselves at the expense of the company, but also provided short-term accounting benefits that enabled Enron to materially overstate its earnings. Enron exploited accounting benefits that would not have been available in arm's length transactions with third parties.

Likewise, Parmalat's underlying problems were due to the massive fraud that was facilitated by the prevalence of special purpose entities (SPEs) and offshore subsidiaries that were used by the managers and officers to carry out illicit related party transactions. But, unlike Enron, it was Parmalat's family-controlled management and advisors that structured the group's various financial arrangements to enrich members of the Tanzi family at the expense of the shareholders and other stakeholders. Nevertheless, Parmalat is often described as the European Enron. To

see this consider the following facts. Until its collapse, the Parmalat Group was one of the world's largest leading dairy and food products groups with operations in more than 30 countries worldwide. The company, which was controlled by the Tanzi family and operated out of Collecchio, Parma, was formed in the 1960s as a classic food trading concern. The family-controlled business was rapidly transformed, as a consequence of innovations in the processing of milk (UHT), into a dairy company, and thereafter quickly extended its operations into foreign and food-related markets. By the 1980s, the group had diversified into non-food-related markets. However, these ventures were unsuccessful, which eventually led to financial problems. In order to redress these financial problems, Coloniale restructured the group, and Parmalat Finanziaria, the listed holding company, emerged.

In the 1990s, Parmalat continued its expansion of its dairy and food services and diversified into tourism and the professional sports sector through the sponsorship of a number of domestic Italian and foreign football teams. For Parmalat, most of these investments were loss making from their inception. Having extended its reach to North and South America to more than fifty companies by the end of the decade, Parmalat derived most of its income internationally. Parmalat financed its ambitious growth expansion strategy by a combination of national and international debt issues and equity.

In 2001, Parmalat suffered financial difficulties with its operations in Latin America, which, if known to the market, would have led to higher costs of capital. In order to appear investor-friendly, Parmalat artificially enhanced its consolidated income statements and balance sheets while taking actions to conceal its ever-increasing debt mountain. This led top management and officers, in turn, to undertake a series of paper trail transactions designed to systematically mislead investors regarding certain assets and liabilities. For example, Parmalat's management created false documentation and bank accounts to improve their cash position. As part of this effort, a letter from the Bank of America was created confirming a €3.9 billion bank account of Bonlat Financing Corporation, a Parmalat subsidiary incorporated in the Cayman Islands.<sup>6</sup> This false confirmation letter was used by Bonlat's auditors to certify its 2002 financial statement. Moreover, as part of its fraudulent effort, Parmalat supported its 2003 offerings of unsecured notes to US

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<sup>6</sup> In re Parmalat Securities Litigation: Master Docket 04 Civ 0030 (LAK) ECF Case, First Amended Consolidated Class Action Complaint for Violation of the Federal Securities Laws, United States District Court (SDNY).

investors by disclosing Bonalat's 2002 certification and its 2002 audited financial statement, which included references to a non-existent bank account.

During the years 2002 and 2003, the Parmalat Group encountered questions from supervisory authorities and gatekeepers about the quality of its financial statements and disclosures. For example, a February 2003 bond issue was cancelled due to concerns over debt sustainability and accounting problems. Subsequently the placement of private bonds in July 2003 led to regulatory pressures from Consob, the Italian financial regulator, when Parmalat Finanziaria's statutory auditor, Deloitte, cast doubt on financial statements. On 8 December 2003, the Parmalat Group was unable to make payment on a bond expiry, which led Standard and Poors to downgrade its debt to junk status. Meanwhile, Calisto Tanzi resigned as CEO on 15 December after acknowledging that company records were false, which the Bank of America confirmed on 19 December 2003. The company filed for bankruptcy on 23 December and was declared insolvent on 27 December 2003.

In the end, between 1990 and 2003, the Parmalat Group increased its total debt by €13.2 billion, while generating €1 billion from operations. But it spent €5.4 billion for unproductive acquisitions, €5.3 billion in bank charges and commissions, and €2.3 billion in financial diversions. From this perspective, then, the behavior of the Parmalat Group is immediately apparent. The expansion strategy was a costly failure that led to huge losses. The financial structure of the group needed to be expanded in order to support significant diversions of private benefits, the rapidly deteriorating balance sheet, and the costly arranging and borrowing fees. The architects of the fraud had anticipated that their strategy of foreign expansion and corresponding exploitation of weak foreign and Italian governance systems would allow them to exploit minority shareholders and creditors for a reasonably long period. If nothing else, the detailed investigations into Parmalat's collapse revealed the extent to which inefficient controlling shareholders employed a huge variety of sophisticated techniques to tunnel assets, profits and corporate opportunities. For instance, Parmalat's controlling family used a virtual hydra head of offshore subsidiaries and chains of companies to cover up their losses and prop up the financial situation of the group.

The Enron and Parmalat cases showed the need for new legal mechanisms to address the governance problems triggered by controlling shareholders and the use of chains of corporate vehicles. While there were numerous conventional legal strategies available to curtail management's capacity to carry out self-dealing



transactions, lawmakers have strengthened regulation in the core areas of audit and auditors, non-executive directors, and board structure. Yet, the recent financial crisis seems to indicate that the legal protections and increased focus on corporate governance are not the whole story.

Perhaps the most important challenge lies on the disclosure side. Arguably, investor confidence in financial markets depends in large part on the existence of an accurate disclosure and reporting regime that provides transparency in the beneficial ownership and control structures of listed companies. This is particularly true for corporate governance systems that are characterized by concentrated ownership. As we have seen, controlling beneficial owners with large voting blocks may have incentives to divert corporate assets and opportunities for personal gain at the expense of minority investors and other stakeholders. Obviously, protecting the interest of minority investors will be difficult without access to reliable information about the ownership, including the identity of the controlling owners, and control structures of listed companies. Still, the current debate on disclosure rules and regulations reveal significant differences of opinion regarding the extent to which stringent mandatory disclosure rules can prove effective in discouraging illicit, related party transactions.

### **3. Disclosure of Beneficial Ownership**

#### **3.1 *Inside and outside ownership: costs and benefits***

In the aftermath of the financial crisis, policymakers and regulators are again concerned with designing a corporate governance framework that is better able to protect investors from misbehaviour and self-interested managers and controlling shareholders. The debate focuses on the principal-agent relationship between those with actual control over the company and minority investors, other stakeholders, such as employees, customers and suppliers, and society in general. In so-called market systems, which are characterized by widely dispersed, small and numerous shareholdings and thick, liquid trading markets, the emphasis of the discussion is mainly on creating mechanisms that are intended to curtail Enron-type agency problems between self-interested management and passive investors.<sup>7</sup> These problems can largely be explained by the “vertical agency relationship” in which the

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<sup>7</sup> See W.W. Bratton and J.A. McCahery, *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, 2 *Theoretical Inquiries in Law* 745, 2001.

managers are the agents and the shareholders are the principals (see Figure 1). The agency problems in market systems stem from shareholders being passive and not at all engaged in monitoring and, if necessary, disciplining management. In economics jargon, the “separation of ownership and control” provides management with the opportunity to use superior information about a company’s strategies, policies and prospects opportunistically and self-interestedly, without the risk of being detected.

In concentrated ownership or blockholder systems, found in many variations in Europe, Asia and most other capitalists economies, the magnitude of the “vertical agency problem” is mitigated because some investors tend to have larger stakes in listed companies and hence have more incentives to monitor and discipline management. Here, one should distinguish between two types of listed firms in blockholder systems (see Figure 1). Firstly, there are listed companies, such as most institutional investor “controlled” companies, in which the substantial voting rights and cash-flow rights are identical and based on the proportion of total shares held. These investors, generally referred to as “outside blockholders”, make listed companies prone to a three-way conflict between controlling shareholders, managers and minority shareholders. Since outside blockholders usually mitigate the problems related to managerial opportunism, it is not surprising that policymakers and regulators focus on possible conflicts that may occur in the “horizontal agency relationship” between outside blockholders and passive minority investors.<sup>8</sup> To see this, note that in the current financial world, which is typically characterized by high frequency trading and rapid and continuous changes in share ownership, institutional investors are inclined to focus too much on short-term returns.<sup>9</sup> The short-term stance of outside blockholders’ investment strategy makes minority shareholders vulnerable to opportunistic behaviour.<sup>10</sup> For example, recent research shows that before the occurrence of the financial crisis was imminent, powerful institutional investors encouraged managers of their portfolio companies to pursue more risky

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<sup>8</sup> See L.A. Bebchuk and R.J. Jackson Jr., *The Law and Economics of Blockholder Disclosure*, The Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 702, July 2011.

<sup>9</sup> See C. Van der Elst and E.P.M. Vermeulen, *Europe’s Corporate Governance Green Paper: Do Institutional Investors Matter?*, Lex Research Topics in Corporate Law & Economics 2011-2 Working Paper (available at <http://ssrn.com/abstract=1860144>).

<sup>10</sup> The legal framework of a listed company provides parties with a differentiated management and control structure in which shareholders elect directors and participate in certain fundamental decisions, and directors establish policies, select managers, perform monitoring functions, and act as the company’s agents. Because the controlling shareholder elects the directors, they are usually able to practically control the management and supervision of a listed company.

and opportunistic growth strategies in order to spur short-term shareholder returns.<sup>11</sup> The fact that outside blockholders, due to more advanced trading practices and technologies, increasingly use derivative instruments and short-selling techniques in order to make profits just adds to the “horizontal agency problem” between outside blockholders and minority investors.<sup>12</sup>

Secondly, recall the Parmalat example. Listed companies are predominantly family-owned - and sometimes even state-owned - companies with inside blockholders, who actually hold management positions or serve on the board of directors of the companies they invest in (see Figure 1).<sup>13</sup> Obviously, “vertical agency problems” are irrelevant, but “horizontal agency problems” abound in these listed companies. As we have seen in the Parmalat-case, the controlling shareholders may employ several strategies to extract resources and assets from firms they control, thereby significantly increasing the horizontal agency costs. These include: (1) dilutive share issues, (2) insider trading, (3) withholding important information, (4) allocation of corporate opportunities and business activities, and (5) related party transactions. As the Parmalat example shows, the key concern about related party transactions is that they may not be undertaken at market prices, calling for strict disclosure and reporting regimes that provide minority investors with information about the blockholder’s controlling identity, interest and intentions.<sup>14</sup>

### **3.2 The importance of “strict” disclosure and reporting mechanisms**

There is a wide array of legal mechanisms designed to prevent or restrict corporate actions that may lead to opportunistic behaviour by blockholders. For instance, pre-emption rights in company law statutes give all shareholders in a company the right to be offered any newly issued shares before the shares are offered to either non-shareholders or one or more of the existing shareholders. Because the offer of new shares to existing shareholders must usually be made on a

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<sup>11</sup> See D.H. Erkens, M. Hung and P.P. Matos, Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide, ECGI - Finance Working Paper No. 249/2009.

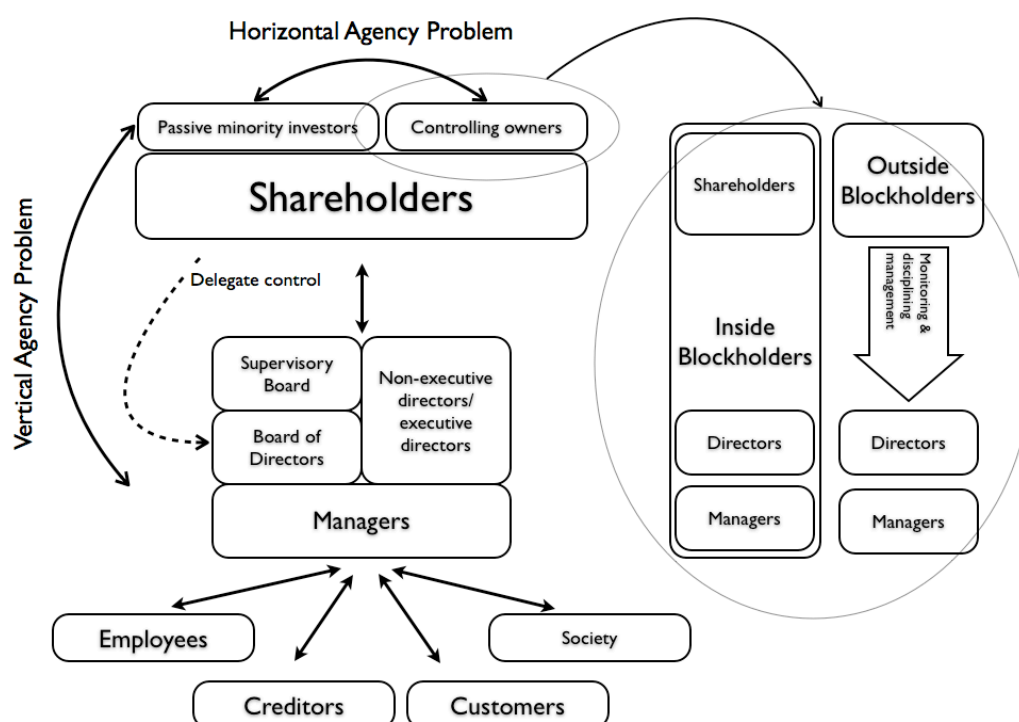
<sup>12</sup> When institutional investors sell short, they sell borrowed shares under the expectation that they will be able to buy the shares back in the market at a lower price.

<sup>13</sup> See C.G. Holderness, A Survey of Blockholders and Corporate Control, FRBNY Economic Policy Review, April 2003.

<sup>14</sup> It should be noted that related party transactions play an important and legitimate role in a market economy. For firms, trade and foreign investments are often facilitated by inter-company financing transactions. Lower costs of capital and tax savings provide a strong incentive for engaging in related party transactions. Indeed, there are many examples of related party transactions that yield benefits for companies. The most popular transactions include (1) inter-company loans or guarantees from parent to foreign subsidiary, (2) a leasing or service agreement between a parent and a foreign subsidiary, and (3) the sale of receivables to a special purpose entity.

pro-rata basis, this legal provision prevents that blockholders expropriate the interests of minority investors by initiating dilutive share issues. Another example of legal provisions that regulate potentially self-dealing transactions can be found in the listing rules of several Asian countries. The listing rules of the Hong Kong and Singapore stock exchanges, for instance, insist that material related party transactions are put to a vote by the minority shareholders of listed companies, providing them with information and control over expropriation attempts.

**Figure 1:** Agency problems in blockholder systems



No matter how effective these mechanisms are, they are not by themselves a sufficient remedy for the legal and regulatory challenges raised by concentrated ownership and blockholders. Indeed, minority investors must have means to monitor and observe blockholders' behaviour in order to detect possible opportunism and expropriation at an early stage. Therefore, the existence of an accurate disclosure and reporting regime that provides transparency in the ownership and control structures of publicly listed companies is considered as the linchpin of an effective corporate governance infrastructure. This conclusion is not new to policymakers and

regulators.<sup>15</sup> Most jurisdictions passed legislation mandating shareholders to disclose and report the accumulation of a substantial ownership of shares (see Table 1). The reporting requirement includes the ownership of bearer shares, which is often still considered legal and appropriate. Bearer shares are normally not registered in a shareholders register, making it almost impossible to quickly determine the identity of the shareholders. To be sure, registration with the company is often necessary if holders of bearer shares intend to vote or want to receive dividends. Without effective disclosure and reporting requirements, however, bearer shares would enable shareholders to secretly acquire potential control over a listed company, thereby facilitating market manipulation and abusive tactics.

**Table 1:** Disclosure thresholds across countries (2005)

Country	Threshold	Country	Threshold
Italy	2%	Sweden	5%
UK	3%	Switzerland	5%
Brazil	5%	Turkey	5%
China	5%	US	5%
France	5%	Argentina	5%
Germany	5%	Russia	25%
India	5%	Canada	10%
Japan	5%	Chile	10%
Malaysia	5%	Pakistan	10%
Netherlands	5%	Latvia	10%
Spain	5%	Mexico	No

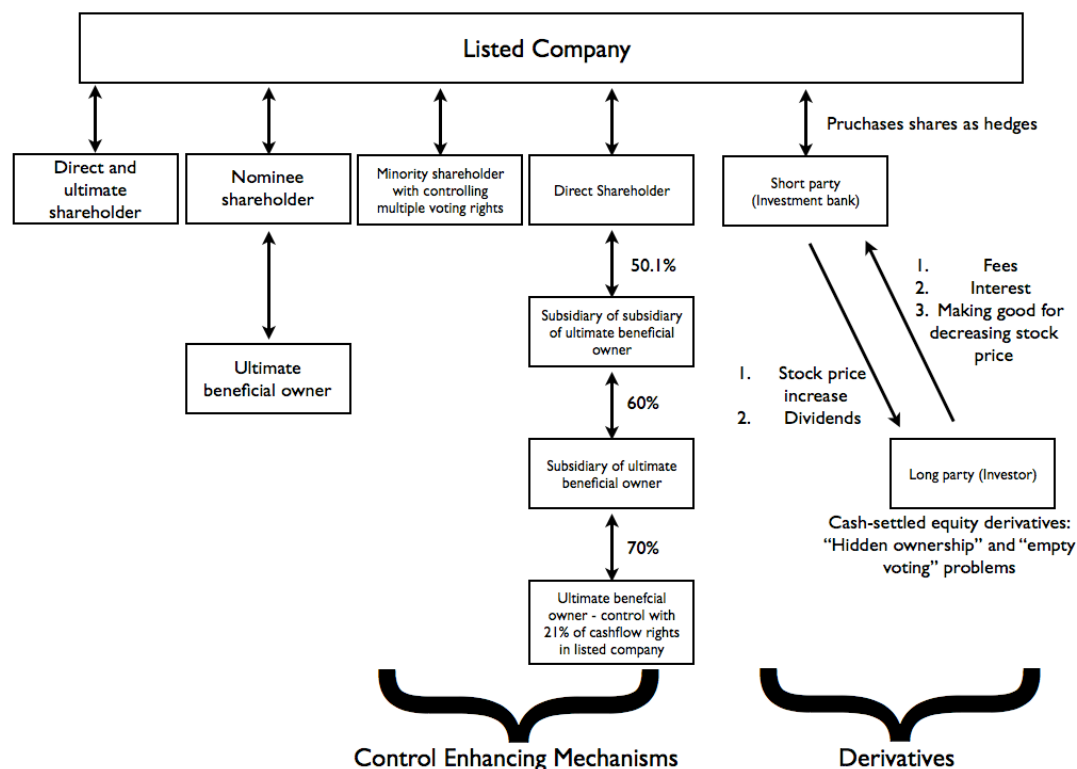
*Source: Adapted from M.C. Schouten and M.M. Siems, The Evolution of Ownership Disclosure Rules Across Countries, 10 Journal of Corporate Law Studies 451*

The rationale behind the disclosure requirements is clear: to alert minority investors to material changes in corporate control and ownership structures and to enable them to make an informed assessment of the effect of these changes. Still, there is more to be done. The effect of disclosure and reporting requirements

<sup>15</sup> See F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, 1991.

depends largely on the scope and definitions of ownership and control. Even if the use of bearer shares is abolished or restricted, there are a number of other legitimate ways to conceal the true identity of the ultimate beneficial owner of a company's shares. The picture of ownership and control will thus still be blurred if there is no disclosure or reporting requirement for the "ultimate" beneficial owners to reveal their identity. For instance, if disclosure must only be made at the level of direct shareholders, the use of nominee shareholders, other intermediaries, chains of corporate vehicles or equity derivatives will mask the identity of investors (see Figure 2).

**Figure 2:** The need to disclose the ultimate beneficial owner



Source: Adapted from D. Zetzsche, *Continental vs. Schaeffler, Hidden Ownership and European Law - A Matter of Law or Enforcement?*, Heinrich-Heine-University Duesseldorf, Faculty of Law, Center for Business and Corporate Law Research Paper Series (CBC-RPS)

### *3.2.1 Nominee and omnibus accounts*

In practice, a nominee shareholder is typically a company created for the purpose of holding shares and other securities on behalf of investors. They hold the shares on trust for one or more beneficial owners, and often only they are identified on the register of shareholders. Usually, foreign investors have to open single-client nominee accounts because their global account provider is not permitted to participate directly in a local Central Securities Depository (CSD). The concern for regulators is clear: the appointment of nominee shareholders would, in effect, provide beneficial owners with the opportunity to shield their identity from investors and other stakeholders, making it more difficult to detect expropriation by controlling beneficial owners.

Likewise, policy makers and regulators increasingly express concerns about omnibus accounts. An omnibus account is a securities account that involves many investors. Although the account is opened in the name of the account provider, it should be viewed as an umbrella which covers a large number of individual accounts. Omnibus accounts seriously reduce transaction costs that are due to clearing and settlement fees and procedures. However, because the breakdown behind the omnibus accounts is often hidden for the listed companies and their investors, they could also be viewed as just another attractive instrument to conceal the identity of beneficial owners.

### *3.2.2 Derivatives*

Recently, cash-settled equity derivatives and related techniques are used to obtain effective control of the underlying shares without the need for disclosure under the transparency and disclosure regimes. To see this, consider the following transaction: an investor (also called holder of the long position) purchases and acquires from a derivatives dealer or bank (the holder of the short position) a long cash-settled swap covering the underlying shares in a listed company. Under the agreement between the holder of the long position and the holder of the short position, the investor benefits from price increases in the underlying shares and incurs losses if the price decreases. The derivatives dealer usually assumes a neutral risk position by physically acquiring the underlying shares at the strike price of the derivative. The swap arrangement thus results in a decoupling of the voting rights from the beneficial ownership of the shares. The decoupling leads to “hidden

ownership” and could also result in “empty voting” issues.<sup>16</sup> Hidden ownership refers to the situation where a cash-settled equity derivative gives the investor a long position in the shares of a listed company that remains undisclosed until the investor physically acquires the shares or the settlement arrangement is formally changed from a cash settlement to a physical settlement. Empty voting occurs when the derivatives broker votes the shares as directed by the investor.

### *3.2.3 Control enhancing mechanisms*

Investors often employ complex control and ownership arrangements designed to give them voting/control rights in excess of their cash flow rights. These arrangements are commonly employed by inside blockholders who usually have voting control, even if they ostensibly have no majority stake in the company. Voting rights can, for instance, be separated from cash flow rights by setting up pyramid or cross-shareholding structures, issuing multiple voting rights shares, and participating in shareholder coalitions. Ownership pyramids or cascades are the most widely used mechanism to accumulate control power with a relatively limited investment in most countries in the world. For instance, Table 2 shows that pyramid structures prevail in Europe. They enable a shareholder to maintain control through multiple layers of ownership while at the same time sharing the investment with other (minority) shareholders at each intermediate ownership tier. Pyramid structures reduce the liquidity constraints of large shareholders while it allows those shareholders to retain substantial voting power.

In a similar vein, the issuance of multiple voting rights shares provides shareholders with control in excess of their share ownership. The separation of beneficial ownership from control rights (or voting rights) results in significant private benefits beyond the usual financial return on the shares. The negative effect of concentrated ownership is reflected in the size of the control premium. This is the difference between the market value of shares, and how much someone is willing to pay for those shares if they confer (or maintain) control over a company. The existence of a control premium reflects the gains that majority shareholders can make at the expense of minority shareholders. The size of the control premium depends on a number of factors, including the competition in the market for corporate

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<sup>16</sup> See H.T.C. Hu and B. Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Business Lawyer 1011, 2006; E.S. De Nardis and M. Tonello, Know Your Shareholder: The Use of Cash-Settled Equity Derivatives to Hide Corporate Ownership Interests Conference Board Director Notes No. DN-009, July 2010.



control, the size of the block sold, the distribution of shares in the target firm, the inequality of voting power, the nationality of the buyer, and the financial condition of the firm involved. The existence of large private benefits of control suggests that blockholders may be able to obtain a large share of the rents. For instance, the holder of multiple voting rights shares is usually allowed a seat on the board of directors and will thus receive non-public information on the company's cost structure and performance.

**Table 2:** Control Enhancing Mechanisms in Europe

Control Enhancing Mechanisms	Availability	Actual Use
Pyramid structure	100%	75%
Shareholders agreement	100%	69%
Cross-shareholdings	100%	31%
Supermajority provisions	87%	N/A
Multiple voting rights shares	50%	44%

*Source: Report on the Proportionality Principle in the European Union, External Study Commissioned by the European Commission 2006.*

Control enhancing mechanisms are prone to severe agency problems, which support calls for improvements in the corporate governance infrastructure of most countries. The question is what type of legal rules and other regulatory strategies will best serve the infrastructure's goal of limiting the effects of self-interested transactions involving controlling shareholders. In response to the weaknesses of a corporate governance infrastructure, policymakers could address the agency problems by either banning control enhancing mechanisms or by providing increased transparency and disclosure. The first option, however, may have some detrimental effects on the innovative and entrepreneurial potential of fast-growing listed companies,<sup>17</sup> making disclosure and reporting requirements for control enhancing mechanisms the preferred option.

<sup>17</sup> For instance, Google, Inc., a Delaware corporation, decided to extend the "Google way" of doing business to its corporate governance structure. At some point in time, the Google founders and its Chief Executive Officer owned approximately 90 percent of the outstanding class B shares, giving them 68% of the firm's total voting rights while their economic interest was only approximately 20% (making them inside blockholders). The multiple voting rights shares did not seem to withhold investors to buy class A Google shares. In fact, these investors could actually consider Google's multiple voting rights share structure as good practice during the growth and development stage of the listed company, because it

### *3.2.4 Chains of corporate vehicles*

Chains of corporate vehicles could also be used by controlling beneficial owners to conceal their true identity and set up complex ownership structures and arrangements in listed companies. To be sure, companies may have legitimate or clear economic motives to use chains of corporate vehicles. However, the use of a chain of local and offshore corporate vehicles or international holding structures is sometimes an indication that controlling beneficial owners engage in abusive and opportunistic behaviour. Whilst misuse of corporate vehicles is often difficult to discover, it is acknowledged that (potential) misuse of corporate vehicles can be limited by the maintenance and sharing of information on beneficial ownership and control in the corporate vehicle through a number of legal and regulatory measures. These measures include: (1) an up-front beneficial ownership disclosure to the public authorities and official intermediaries, (2) mandating private corporate service providers to maintain beneficial ownership information, and (3) primary reliance on an investigative system. In the Section 5 of this essay, we discuss the mechanisms to hide the identity of the beneficial owners of corporate vehicles in more detail. More importantly, we critically assess the ability of anti-money laundering and anti-terrorism rules to provide transparency in the area of ownership and control in listed companies, thereby protecting minority investors in general.

### **3.3 *Beneficial ownership and control: the challenges***

The difficulties involved in tracing ultimate beneficial ownership and, more importantly, control make it onerous for minority investors and other stakeholders to discover and curtail self-dealing, such as asset stripping, related party transactions and share dilutions by the ultimate controlling beneficial owners. Not surprisingly, the recent financial crisis calls for stricter disclosure and reporting rules that help uncover the complicated control structures used by ultimate beneficial owners of listed companies. On March 7, 2011, for instance, the Securities and Exchange Commission (SEC) of the United States received a petition for rulemaking submitted by a law firm recommending amendments to the regulatory provisions that govern disclosures required by persons who “beneficially own” more than five percent of a

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gives controlling shareholders (the founders) an incentive to monitor the firm closely and exposes the founders personally to the firm’s public shareholders and other stakeholders. The fact that Google ranked high on the Financial Times Global 500 largest companies in 2010 seems to indicate that the control enhancing mechanisms do not necessarily have a detrimental effect on firm value.

class of equity securities of a publicly listed company.<sup>18</sup> The petition specifically requests that the time period within which beneficial ownership reports must be filed with the SEC be shortened pursuant to new statutory authority provided in Section 13(d) of the Securities Exchange Act of 1934. The petition also asks the SEC to broaden the definition of beneficial ownership to include ownership interests held by persons who use derivative instruments. The proposed amendment would ensure that investors have information about all persons who have the potential to change or influence control of the issuer.

There is something to the call for stricter disclosure and reporting rules and regulations. Investors fare better in a corporate governance environment that allows beneficial owners to acquire control either directly or indirectly through derivatives or chains of corporate vehicles (if this meets a company's specific governance needs and requirements) than in a system that prohibits beneficial market activity.<sup>19</sup> In order to protect minority investors, policymakers and legislatures should therefore consider the introduction of clear and stringent disclosure and transparency obligations that offer minority investors a true picture of ownership and control structures and, more importantly, reveal the identity of the persons who should be considered as the ultimate beneficial owner.

Indeed, a good corporate governance infrastructure should ideally combine large investor involvement with legal protection of minority investors. Obviously, minority investor protection will be challenging without access to reliable information about the ownership, including the identity of the controlling owners, and control structures of listed companies. However, despite clear benefits, a disclosure and reporting regime has its costs as well. A recent analysis cast doubt on whether the rules in the United States should be tightened.<sup>20</sup> Firstly, it is argued that empirical research has shown that controlling beneficial owners provide benefits to other shareholders "by making incumbent directors and managers more accountable, thereby reducing agency costs and managerial slack." Secondly, tighter disclosure rules could seriously decrease blockholders' incentives to engage in monitoring. For instance, outside blockholders' monitoring and disciplining activities can be explained by a listed company's stock price not reflecting the company's potential. A (too) strict

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<sup>18</sup> See Wachtell, Lipton, Rosen & Katz, Letter to the Securities and Exchange Commission - Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, 7 March 2011.

<sup>19</sup> See also M. Kettunen and W-G Ringe, Disclosure Regulation of Cash-Settled Equity derivatives - An Intentions-Based Approach, University of Oxford, Legal Research Paper Series, July 2011 (available at <http://ssrn.com/abstract=1844886>).

<sup>20</sup> See L.A. Bebchuk and R.J. Jackson Jr., The Law and Economics of Blockholder Disclosure, The Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 702, July 2011.

and disproportional disclosure and reporting regime that obliges a blockholder to disclose its position at a very early stage without being able to benefit more from relatively low stock prices, would arguably discourage them to engage in monitoring, thereby increasing “vertical agency costs”. Indeed, public information about the presence of outside blockholders will have a price increasing effect on a listed company’s stock price and, as a consequence, reduce the incidence and size of outside blocks. Thirdly, it is not certain that the current trading technologies and practices, such as cash settled derivatives, have led to increased accumulations of ownership. Fourthly, strict disclosure regimes tilt the playing field against blockholders monitoring activities. Indeed, a disclosure and reporting regime could target several types of beneficial owners: (1) passive beneficial owners who are only interested in a company’s share price, (2) beneficial owners who monitor the performance of listed companies and initiate dialogues with management, and (3) beneficial owners that seek to acquire control over a listed company. Clearly, the market is particularly interested in the third category of beneficial owners. Targeting the whole range of beneficial owners could discourage legitimate blockholders’ activities. Finally, it is argued that tightening the disclosure regime cannot be justified on the grounds that it is needed to protect minority investors. A stringent disclosure and reporting regime could lead to information overload. Stricter disclosure and reporting requirements that increase the complexity and quantity of information in the financial market, make it more difficult for minority investors to make informed and considered choices regarding their investments. This is especially true if rules and regulations endeavour to target ownership through complex derivatives arrangements even if the “owner” does not seek control.<sup>21</sup>

It follows from the above discussion that the design of a balanced and effective disclosure and reporting regime into a country’s corporate governance framework poses something of a challenge. Who - and at which shareholders level - should report a stake in a listed company? When should the disclosure be made and to whom? What should be disclosed? Through which channels should beneficial ownership and control be reported? Who will have access to the reported information? Arguably, countries need a proportionate and flexible reporting and disclosure regime to combine the best of two “worlds”: protection against opportunistic (inside) blockholders without creating disincentives for (outside) blockholders to intervene in badly managed companies (see Table 3). Obviously, in

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<sup>21</sup> See M.K. Brunnermeier and M. Oehmke, Complexity in Financial Market, Working Paper, 2009.

order to have practical relevance, the disclosure and reporting requirements for beneficial owners should be complemented with effective rules that directly target intra company transfers and other related party transactions.

**Table 3:** Beneficial Ownership and Control: The Challenges for Policy Makers and Regulators

Outside blockholders	Inside blockholders
<b>The good:</b> Outside blockholders have an incentive to improve management by making incumbent directors and managers more accountable and thereby reducing agency costs and managerial slack.	<b>The Good:</b> Inside blockholders tend to overcome underinvestment problems. Moreover, fast-growing and innovative listed companies tend to benefit from the presence of inside blockholders.
<b>The Bad:</b> Outside blockholders could decide to pursue short-term opportunistic activities.	<b>The Bad:</b> Inside blockholders have a strong incentive to reap private benefits of control through self-dealing and insider trading.
<b>The disclosure regime</b> should not be too stringent. Outside blockholders invest in monitoring in their belief that the actual (low) share price does not reflect the true value of the company. Empirical research shows that their monitoring activities protect minority investors against managerial slack. The share price will increase dramatically when the presence of outside blockholders is disclosed. This has a negative effect on the incentives of the blockholders to buy additional shares to increase their stake, preventing them from becoming a stronger blockholder and reducing their expected returns.	<b>The disclosure regime</b> should be stringent and demanding. Inside blockholders have an incentive to protect their private benefits of control at the expense of minority investors.

*Source: Adapted from L.A. Bebchuk and R.J. Jackson Jr., The Law and Economics of Blockholder Disclosure, The Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 702, July 2011; X. Chen and J. Yur-Austin, Re-measuring agency costs: The effectiveness of blockholders, 47 The Quarterly Review of Economics and Finance 588, 2007; A. Ferrell, The Case for Mandatory Disclosure in Securities Regulation Around the World, Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 492, 2004.*

## **4. Related Party Transactions**

As noted above, the Enron and Parmalat scandals illustrate the difficulty that auditors and regulators face in identifying related party relationships and transactions that are motivated by fraud or illicit earnings management. While there is widespread agreement on the need to regulate related party transactions, there is much less convergence on what transactions should be subject to deterrent regulation.

### **4.1 *Why should one care about related party transactions?***

The received wisdom is that related party transactions play an important and legitimate role in a market economy. For firms, trade and foreign investment is often facilitated by inter-company financing transactions. Lower costs of capital and tax savings provide a strong incentive for engaging in these transactions. Indeed, there are many examples of related party transactions that yield benefits for companies. By far the most popular transactions include (1) inter-company loans or guarantees from parent to foreign subsidiary; (2) the sale of receivables to a special purpose entity, and (3) a leasing or licensing agreement between a parent and a foreign subsidiary. A key concern about related party transactions is that they might not be undertaken at market prices but can be influenced by the relationship between the two sides of a transaction: there is a conflict of interest for some person in the company. For both inside blockholders and other insiders such as management, related party transactions can be the mechanism for extracting private benefits of control at the cost of other shareholders. There are a broad array of legal strategies to regulate disclosure of related party transactions and conflicts of interests.

A large body of literature has considered these issues by referring to the American experience with conflicted transactions by management and controlling shareholders. It is important to recognize that US law once prohibited interested transactions involving managers and directors. But the strategy for prohibiting self-dealing transactions underscores a particular political-legal tradition rather than a credible means to protect private investors and foster a more equitable distribution of wealth in society. Accordingly, the prohibition strategy failed to deter reallocations of wealth. In fact, aside from providing little protection against a single undetected transaction, the prohibition of self-dealing may have left many companies worse off as a consequence of preventing many efficient transactions.

This prompted the need for regulators to allow companies to pursue certain related party transactions not leading to conflicts of interest. The shift in self-dealing rules reflected the view that some non-abusive transactions are valuable and that parties should have incentives to pursue these transactions. US company law rules provide that self-dealing transactions are permitted subject to legal controls. To protect outside investors from abusive transactions, state and federal laws regulate self-dealing, corporate opportunities, insider trading, and the compensation agreements with executives.

However, there are suggestions that the modern regulation of self-dealing transactions is misguided. Thus, where managerial value diversion does not raise fairness and distributional concerns, there is no obvious need to protect shareholders against expropriation. Moreover, to the extent that value diversion is an alternative form of compensation, it probably makes little sense to subject conflicted transactions to restrictive legal rules.

Another approach, inspired in part by these views, stresses that the benign view of value diversion is misleading. Managerial value diversion creates significant agency costs by eviscerating the incentive effects of performance-based pay. To be sure, there is evidence that extra-legal mechanisms, such as trust and loss of reputation, can lessen but not eliminate the inefficient subtraction of firm earnings. Notwithstanding these constraints, if the gains of opportunism are very large, legal standards may be insufficient to limit management from engaging in opportunistic behaviour. This is an argument for encouraging more protective measures of minority investors, increased transparency, and stronger shareholder involvement in decisions involving transactions that could implicate a conflict of interest with management or a controlling shareholder.

While there is little agreement on the rationale to regulate related party transactions, there is even much less consensus on what transactions should be subject to deterrent regulation. To be sure, the nature of the problem varies: in companies with controlling shareholders and with corporate groups, the measures need to be different from those situations where ownership is spread and where the board and management is effectively entrenched.

#### **4.2 *Identifying related party transactions: the challenges***

Various terminology and definitions are employed to define related parties and related party transactions across jurisdictions. In the US, the Financial

Accounting Standards Board's (FASB) Statement no 57 provides that related party transactions involve transactions between a parent company and subsidiary; subsidiaries of a common parent; an enterprise and trusts for the benefit of employees; an enterprise and its principal owners, management, or members of their immediate families; and affiliates.<sup>22</sup> It is unlikely, however, that there is a simple definition that is sufficient for identifying all the transactions with related parties. A second ground for eliminating this approach is that certain complex transactions, which fail to meet the relevant criteria, may be too easily excluded on these grounds. Ruling out this approach is an important step for developing a basis to identify these transactions.

Seen in this light, the attempt to identify related party transactions raises complex issues. That said, the nature of related party transactions is best highlighted by general principles such as those of the International Accounting Standards Board rather than listing categories of people and entities. According to IAS 24, parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions. Related party transactions are defined as a transfer of resources or obligations between related parties, regardless of whether or not a market price is charged. The OECD Principles take a similar approach and state that related parties can include entities that control or are under common control with the company, board members, and significant shareholders, including members of families and key management personnel.

Transactions involving major shareholders or their close family either directly or indirectly are potentially the most difficult types of transactions to identify. Again, the Enron and Parmalat scandals illustrate the difficulty that regulators face identifying related party relationships and transactions that are motivated by fraud. The complications arise not only from the complexity of many of these transactions, but also involve auditors' problems of detecting material misstatements in financial statements due to a related party transaction.

There is no question that the American Institute of Certified Public Accountants' (AICPA) Statement of Auditing Standard no 45, AU Sec 334 (2001) has supplied a feasible approach for identifying material transactions, such as interest-free borrowing, asset sales that diverge from appraisal value, in-kind transactions, and loans made without scheduled terms. Other indicators can be used as well to

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<sup>22</sup> FASB Statement no 57 Related Party Disclosures.



detect potential opportunism. One possibility is to have auditors obtain information about management responsibilities to run the company, controls over management activities, and management arrangements with various components of the entity. At the same time, AU Sec 334 can be used to identify the existence of related party transactions. Company auditors can employ a range of audit procedures, from the review of non-recurring transactions to the invoices of regular services, to evaluate conflicted transactions.

There is satisfactory transparency regarding related party transactions for all listed companies with the European Union under IAS 24 and under the national codes. In terms of disclosure of related party transactions, regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so must also be disclosed (see IAS 24.12). Furthermore, IAS 24 mandates that for each category of related parties, companies should disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements (see IAS 17-18). Such disclosure should include the amount of the transactions, the amount of outstanding balances, provisions for doubtful debts related to the amount of outstanding balances, and expenses recognized during the period in respect of bad or doubtful debts due from related parties.

Nevertheless, there are numerous techniques that parties use to avoid the IAS 24. As we have seen earlier, the controlling shareholder is able to obtain non-public information and use it for personal financial benefit or tip other family members – who might then make an investment decision on the basis of the information. The inaccuracy of public information is less pressing if a minority shareholder is also a director in a company. In that case, he will be able to influence and monitor management decisions directly. Legally requiring shareholder approval may have the same effect. However, if minority shareholders are not in a managerial capacity or involved in the decision-making process, they are unlikely to gather the information without relying on a legal mandate.

Thus, even though enhanced financial statement transparency should be encouraged, regulators must not underestimate the higher costs of disclosure for

those non-listed companies. If the idea is to increase the accountability of companies, regulators may need to subject disclosure of related party transactions on an aggregate basis.

## **5. Disclosure of Beneficial Ownership of Corporate Vehicles**

Off balance sheet corporate vehicles played an important role in the Enron scandal and the built-up to Parmalat's troubles. In this context, it is important to evaluate their purpose and their multitude of uses in financial transactions. Indeed, modern corporate vehicles are diverse and serve a range of complex needs for business parties. At their core, they allow business people to carry out important commercial activities. Organizing these activities through corporate vehicles solves a number of contracting problems while contributing to the development of a sophisticated and complex economic environment. The flexibility and adaptability of corporate vehicles to accommodate the financial and organizational needs of entrepreneurs and investors have arguably contributed to the deepening of financial markets. Irrespective of how effective these forms might be for meeting the needs of a broad range of businesses and investors, there have been increasing concerns about the degree to which these forms are used for tax evasion, money laundering, and other illegal or abusive transactions. The financial market and banking systems become more international and, in important respects, encourage the development of financial centers. As these centers become more established and accessible, an increasing number of individuals, businesses and opportunistic investors are likely to take advantage of the usually flexible regulation and gate-keeping systems in these centers.

For instance, it is clear that offshore financial centers are not only attractive due to the flexible financial supervision, bank secrecy laws and beneficial fiscal treatment, but equally due to their usually accessible rules regarding the formation and operation of corporate vehicle.<sup>23</sup> It is a common refrain that controlling beneficial owners of company shares frequently involve the use of offshore corporate vehicles or international holding structures to conceal the true identity of the shareholders. In fact, some of the major offshore jurisdictions have encouraged investors to move capital and use their financial institutions by creating legislation that effectively restrict the identity of the beneficial owners of the company. Along with the instruments for

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<sup>23</sup> See OECD, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes*, 2001.

achieving anonymity, there are also a variety of legal measures, such as restrictions on gatekeepers and service providers to assist regulators with determining the true identity of parties, that also allow money launders and others pursuing criminal schemes to invest with minimal scrutiny.

As we have seen, there are a number of techniques that make it difficult to establish the true ownership of a company, such as bearer shares and nominee shareholders. Modern corporate vehicles,<sup>24</sup> which are even less regulated than the traditional corporate form for listed companies, are even more apt for establishing chains of corporate vehicles. Lighter rules and regulation provide these entities with a more flexible structure. They can be established cheaply and often online within 24 hours. These characteristics make these types of business forms more vulnerable to misuse for illicit purposes. More importantly in the context of this essay, controlling beneficial owners of listed companies could take advantage of the light regulation of these modern business forms to hide their identity and perpetrate a wide range of illegal or abusive activities. We already noted that inside blockholders often hide their identity by establishing a chain of local and offshore corporate vehicles.

This next Section begins with a review of the legitimate aims of corporate vehicles and their potential for misuse by parties to engage in illicit activities. We describe and analyze the competing methods for identifying beneficial ownership and control. The primary objective of this Section is to assess whether the disclosure regime for corporate vehicles can be used as an investigative tool for minority investors and other stakeholders to obtain information about the beneficial ownership and control structures, including the identity of beneficial owners, of listed companies.

### **5.1 *Corporate vehicles and their potential for misuse***

There are many of techniques available to move money swiftly and effectively to evade tax authorities and other enforcement officials. Specialists on financial crime and money laundering frequently note that perpetrators seek to avoid detection by creating a chain of company law vehicles in separate jurisdictions. Corporations, trusts, foundations, limited partnerships and now hybrid business forms, such as the limited liability partnerships (LLPs) and limited liability companies (LLCs), are the vehicles most commonly associated with misuse. These corporate vehicles are

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<sup>24</sup> See F.R. Reyes and E.P.M. Vermeulen, Company Law. Lawyers and Innovation: Common Law versus Civil Law, Lex Research Topics in Corporate Law & Economics 2011-3 Working Paper (available at <http://ssrn.com/abstract=1907894>). See also J.A. McCahery, E.P.M. Vermeulen, M. Hisatake and J. Saito, Traditional and Innovative Approaches to Legal reform: 'the New Company Law', 8 European Business Organization Law Review 7, 2007.

relatively simple and cost efficient to set up. For example, an offshore company acts as nominee for an offshore principal. In this construction, the nominee company represents the offshore company, and transacts all the contracts and conducts the business on its behalf, including invoicing and accounting. The advantages are clear, namely no invoices or other papers will appear in the file of the offshore principal. Such a construction, moreover, assumes that the nominee company will not trade in its country of incorporation, buy or sell goods in its own name, and sign contracts with the nominee company outside its home jurisdiction. In order to develop the chain, parties will go on to establish companies in a third jurisdiction and so forth. To be sure, setting up a chain of corporate vehicles is usually a cost-effective solution for multinationals in their efforts to establish corporate structures that help optimize the financial results of the group of companies. However, the anonymity created by these structures serves to benefit those involved in criminal activities. In this context, jurisdictions have moved to introduce measures that make information about the beneficial owners that control these chains of companies more readily available.

The OECD (2001), which is concerned to combat corruption and money laundering, has articulated a number of policy objectives in respect of preventing the misuse of corporate vehicles. The emphasis on restricting their misuse is in line with other international initiatives that seek to establish the appropriate standards to assist authorities and financial institutions that could effectively stem cross-border crime. As far as jurisdictions have mechanisms that make it possible to obtain access to beneficial ownership information, it is emphasized that proper oversight and high integrity of the system is necessary to ensure the adequacy and accuracy of the information. It is submitted that the misuse of legal entities can be limited by the maintenance and sharing of information on beneficial ownership and control through a number of mechanisms. These alternative mechanisms include: (1) an up-front disclosure system;<sup>25</sup> (2) mandating corporate service providers to maintain beneficial ownership information;<sup>26</sup> and (3) primary reliance on an investigative system.<sup>27</sup> Table

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<sup>25</sup> An up-front disclosure system requires the disclosure of the beneficial ownership and control of corporate entities to the authorities, chambers of commerce or any other institutions charged with responsibility at the establishment or incorporation stage and imposes an obligation to update such information on a timely basis when changes occur. The obligation to report beneficial ownership and control information to the authorities may be placed on the corporate entity, the ultimate beneficial owner, or the corporate service provider involved in the establishment or management of the corporate entity.

<sup>26</sup> In some jurisdictions, intermediaries involved in the establishment and management of corporate entities, such as company formation agents, trust companies, registered agents, lawyers, notaries, trustees, and companies supplying nominee shareholders, directors, and officers ("corporate service

4 provides a “balance sheet” overview of the costs and benefits of each of these mechanisms.

**Table 4:** OECD options for obtaining beneficial ownership information

Option	Benefits	Costs
<b>Upfront disclosure</b>	<ul style="list-style-type: none"> <li>• improved transparency</li> <li>• beneficial ownership and control information available at all times</li> <li>• strong deterrent effect</li> </ul>	<ul style="list-style-type: none"> <li>• imposes significant costs on business vehicles (especially smaller entrepreneurial businesses)</li> </ul>
<b>The holding of information by intermediaries</b>	<ul style="list-style-type: none"> <li>• implementation is cheap</li> </ul>	<ul style="list-style-type: none"> <li>• costly and time-consuming for companies (particularly when foreign parties are involved)</li> <li>• the client identification and verification rules, and related recordkeeping requirements, represent a potentially costly and cumbersome set of identification practices.</li> <li>• potential for delays in the provision of information <i>ex post</i></li> </ul>
<b>Investigative system</b>	<ul style="list-style-type: none"> <li>• may avoid unnecessary costs and burdens on business vehicles, which may stifle legitimate business formations</li> <li>• maintain a reasonable balance between ensuring proper monitoring / regulation of business vehicles and protecting legitimate privacy interests</li> </ul>	<ul style="list-style-type: none"> <li>• potential for delays in the provision of information</li> </ul>

The OECD approach is based on the premise that the most effective technique to identify the beneficial owner is to, when necessary, pierce through the legal form of corporate vehicles in order to obtain information about the legal owner of the shares or the party that exercises effective control over the vehicle. The

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providers”), are required to obtain, verify, and retain records on the (beneficial) ownership and control of the corporate entities that they establish, administer, or for which they provide fiduciary services.

<sup>27</sup> Under an investigative system, the authorities seek to obtain (through compulsory powers, court-issued subpoenas, and other measures) beneficial ownership and control information when illicit activity is suspected, when such information is required by authorities to fulfill their regulatory/supervisory functions, or when such information is requested by other authorities domestically and internationally for regulatory/supervisory or law enforcement purposes.

argument for pursuing this strategy is largely pragmatic, namely there are an array of effective legal techniques available that permit regulators and other parties to obtain such information. The supervisory authorities, in some markets, subject financial intermediaries involved in the creation of such corporate vehicles to obtain a written declaration of the identity of the beneficial owner and renew verification of the identity of the contracting party or beneficial owner when changes occur during the operation of the business. Not only must financial intermediaries obtain the identification of the beneficial owner, but are bound to establish documents, make the information available to supervisors and retain the information long after the business relationship has ended. At a fundamental level, we see that the misuse of corporate vehicles can be controlled by a combination of mechanisms. Thus the choice between the particular mechanisms will be influenced by the efficacy of the legal system and the enforcement history and level of cross-border cooperation in the market. Differences in the legal traditions and culture will arguably complicate the exchange of information on an international level. In principle, the solution to the problem of disclosure of beneficial ownership appears to be straightforward: (1) Introduce a strong national up-front disclosure system and investigative system and (2) establish international collaborations to facilitate the cross-border exchange of information among regulators. As we will see in the next Section the elements of a sound system of disclosure of beneficial ownership are well known by policymakers.

## **5.2 *An Example: combating illicit use of corporate vehicles in Europe***

Over the last decade or so, the European Union, has undertaken to implement uniform rules in order to curb the misuse of financial centers by criminal organizations and to contain money laundering. Money laundering is defined as the process by which a party conceals the illegal existence, illegal source or illegal application of income and then disguises it in order to make it appear legitimate. Money laundering typically involves a three-step process: placement, layering and integration. There is little disagreement about the steps needed to minimize the incidence of money laundering. However, because money laundering involves numerous forms of corruption, it is difficult to identify, let alone prosecute successfully. Given the harm that money laundering causes to financial markets and the effect that it has in undermining confidence in government and public officials, it is argued that strengthening the weak links in regulation is needed. Particularly, financial intermediaries, who usually have knowledge of the assets implicated in

these transactions and a relationship with the persons that operate the corporate vehicles connected to these illicit activities, play a pivotal role.

In 2005, the European Commission embraced the Third Directive on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, which had to be implemented by 15 December 2007.<sup>28</sup> This Directive builds on existing EU legislation and incorporates the June 2003 revision of the Forty Recommendations of the Financial Action Task Force (FATF). It repealed and replaced the 1991 Directive,<sup>29</sup> as amended in 2001, with the difference that it introduces additional requirements and safeguards for situations of higher risks, such as trading with banks located outside the European Union. In the context of the formation and operation of corporate vehicles, the Directive not only applies to financial services providers, such as auditors, external accountants and tax advisors, but also to legal professionals when they assist their clients in the creation, operation or management of trusts, companies or similar structures. For instance, legal professionals must engage in continuous due diligence activities throughout the course of their relationship with clients to (1) identify their clients and, more importantly, verify their identity on the basis of information obtained from a reliable source, (2) identify the beneficial owner of a client who is a legal person, trust or similar legal structure, (3) understand the ownership and control structure of the corporate client, and (4) report suspicious transactions to the national financial intelligence unit (FIU).

The due diligence and reporting obligations present challenges for legal professionals at two levels.<sup>30</sup> Firstly, the “know your client” rules and requirements represent potentially costly and cumbersome due diligence activities. Secondly, and more worrisome, tensions arise between “transparency” (i.e., the reporting obligation of legal professionals that detect or suspect illicit use of corporate vehicles) and “secrecy” (i.e., client confidentiality and lawyer-client privilege).<sup>31</sup> These tensions made it necessary for FATF to draft and develop principles for legal professionals that help combat money laundering and terrorist financing without undermining the lawyer-client privilege, the duty of client confidentiality or otherwise impeding the delivery of legal services generally. This led in 2008 to the introduction of the

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<sup>28</sup> See Directive 2005/60/EC.

<sup>29</sup> See Directive 91/308/EEC.

<sup>30</sup> See P.D. Paton, Cooperation, Co-option or Coercion? The FATF Lawyer Guidance and Regulation of the Legal Profession, 2010 *Journal of the Professional Lawyer* 165.

<sup>31</sup> See C. Tyre, Anti-Money Laundering Legislation: Implementation of the FATF Forty Recommendations in the European Union, 2010 *Journal of the Professional Lawyer* 69.

Financial Action Task Force RBA Guidance for Legal Professionals (Lawyer Guidance). The 2008 Lawyer Guidance applies to legal professionals who engage in one of the five designated activities (e.g., those who help clients who buy or sell real estate; help create, manage or operate legal persons; or establish or manage trusts or hold client's money).<sup>32</sup> The document was well received by the legal profession in that it adopted a risk-based approach (as opposed to the more detailed rules-based approach). A risk-based approach acknowledges that there is no "one-size-fits-all" solution to the prevention of money laundering and financing of terrorism. Instead, it is founded on the premise that there are finite resources to detect and sanction money laundering and terrorism finance activities. The upshot is that the greatest risks should receive the most attention. For legal professionals, this means that they should focus on their client's location, the nature of their business and the nature of the services requested when assessing whether they are engaged in money laundering or other illicit transactions. Unfortunately, it is too early to assess whether the 2008 Lawyer Guidance generated the coveted effect. It is clear, however, that differences in legal cultures and systems hamper the speedy implementation and development of the 2008 Lawyer Guidance. The Guidance explicitly states that the scope of the terms "legal professional privilege" and "professional secrecy" should be determined by the respective countries. Since these terms have different connotations in different legal cultures, the Lawyer Guidance has not (yet) been able to create a level-playing field for legal services in international transactions.<sup>33</sup>

### **5.3 Combating illicit use of corporate vehicles: the challenges**

In order to obtain information about beneficial ownership and control structures of listed companies, we discussed three possible disclosure systems for obtaining extensive disclosure information about the chain of corporate vehicles that are often employed by beneficial owners to conceal their identity and intentions. There is clear evidence of an association between the ability to obscure the identity of beneficial owners and the use of corporate vehicles to carry out illegal activities.

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<sup>32</sup> See L.S. Terry, An Introduction to the Financial Action Task Force and Its 2008 Lawyer Guidance, 2010 Journal of the Professional Lawyer 3.

<sup>33</sup> See L.L. Hill, The Financial Action Task Force Guidance for Legal Professionals: Missed Opportunities to Level the Playing Field, 2010 Journal of the Professional Lawyer 151; E.S. Podgor, Regulating Lawyers: Same Theme, New Context, 2010 Journal of the Professional Lawyer 191. For instance, even though it is acknowledged that professional service providers have to know the identity of their clients (especially in the context of complex cross-border structures), it was recently pointed out that it is extremely difficult to obtain information regarding foreign clients. See European Commission, Meeting with EU Private Stakeholders on Anti-Money laundering and Counter Terrorist Financing Policy, 17 February 2011.



The incidence of illegal activities, such as money laundering and terrorist financing, carried out through corporate vehicles suggest that this type of problem cannot be ignored and may require a comprehensive solution. However, it is clear that there may not be one efficient solution and that the appropriate system for a particular country may change over time to conform to local conditions and company law traditions.

In this context, it is interesting to note that recently US Senators Levin and Grassley started a lobby for the introduction of the “Incorporation Transparency and Law Enforcement Assistance Act”. Under this proposal, the incorporation of corporate vehicles in the United States would require the collection and retention of identity information for beneficial owners (names, addresses, driver’s license or passport number) of corporations and limited liability companies (LLCs) which are not publicly traded or regulated. Moreover, the beneficial ownership information would be subject to subpoena by law enforcement. Despite the fact that promulgation of the Act would lead to a significant increase of the costs of incorporating in the United States, the Senators are of the opinion that the identification procedures will have a positive impact on the prevention of money-laundering and illicit use of legal vehicles.

In practice, however, the upfront identification of a client (either by public agents or intermediaries) who wants to set up a corporate vehicle is not without difficulties. To give just one example, the identification of residents of foreign countries could severely hamper and delay the formation process. Besides the cultural resistance of some countries to deliver supporting evidence for their residents’ identification, clients often provide incorrect or uncertified copies of supporting documents, which increases the transaction costs regarding the formation and operation of corporate vehicles. Despite these extra costs, professional organizations representing legal service providers are of the opinion that the identification (know your client) procedures have a positive impact on the prevention of money laundering and financing of terrorism.<sup>34</sup> Still, we can observe that the company law reforms increasingly enable business parties to set up corporate vehicles without the intervention of professionals. It could be argued that this trend would only simplify the money-laundering process. However, one must bear in mind that corporate vehicles, in order to conduct activities, often have to open bank

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<sup>34</sup> American Bar Association, Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing, 23 April 2010. See also L.P. Cummings and Paul T. Stepnowsky, My Brother’s Keeper: AN Empirical Study of Attorney Facilitation of Money-Laundering through Commercial Transactions, Working Paper, 24 February 2011.

accounts which require the submission of VAT and corporate ID numbers. In fact, financial institutions remain the most suitable parties to prevent and combat money laundering. In this view, lawyers and other legal professionals provide an extra layer that serves as a safety net in the prevention of the financial system for the purpose of money laundering.<sup>35</sup>

The above discussion leads to a conundrum for policymakers and legislatures in that they have to take at least two main aims of law of corporate vehicles into account that may even be inconsistent and mutually exclusive. The main aims of the law are: (1) offer an organizational structure for parties to conduct their business in a way that is consistent with the “public interest” of society (the prevention of illicit activities), and (2) offer a corporate vehicle form that shuns formation and operation requirements, thereby spurring entrepreneurship and innovation. It appears that the latter function of company law prevails in firms operating in knowledge-intense sectors. Given the importance of entrepreneurship and innovation, governments around the world tend to streamline and modernize their incorporation requirements in order to become more competitive and obtain a better position in the competitiveness rankings. For instance, governments introduce simplified incorporation procedures in order to make it possible to use online systems that facilitate electronic filings of new business registrations. Obviously, the online systems bypass lawyers and other legal service providers in the incorporation process. It should therefore come as no surprise that US Senator Levin, who already in 2009 introduced a bill that would require states to collect and maintain beneficial ownership information upon the incorporation of these vehicles, has so far been unsuccessful.

It is only to be expected that governments, in their efforts to encourage entrepreneurship and job creation, increasingly rely on an investigative system to obtain information about beneficial ownership in corporate vehicles. Arguably, such a system stands or falls with the possibility for public authorities or appointed investigators to have access to the necessary information. It is therefore much more important that an effective enforcement and intervention system should be in place to be able to ensure compliance with the disclosure and reporting regimes for listed companies in a particular country.

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<sup>35</sup> It should be noted that the Third Directive explicitly acknowledges this role by stating in Article 14 of the Directive that member states may permit that legal professionals rely on client due diligence performed by trusted third parties.

## 6. Conclusion

This essay highlights the importance of providing a corporate governance structure that can have an effect on protecting minority investors from conflicts in companies caused by concentrated ownership and control structures. It is crucial to reiterate that the legal and regulatory challenges raised by concentrated ownership are complex and that minority investors must have appropriate mechanisms to monitor and detect potential opportunism and expropriation. The existence of accurate disclosure and reporting requirements that provides transparency in the ownership and control structures of public companies is often viewed as the precondition for an effective corporate governance regime that alert minority investors to material changes in corporate control and ownership structures and to enable them to make an informed assessment of the effect of these changes.

The difficulties involved in tracing ultimate beneficial ownership and, more importantly, control make it onerous for minority investors and other stakeholders to discover and curtail self-dealing. This explains the trend, particularly after the recent financial crisis, toward stricter disclosure and reporting rules that help uncover the complicated control structures used by ultimate beneficial owners of listed companies.

However, we find, consistent with Bebchuk and Jackson, in order not to crowd out the positive effects of the interventions of outside blockholders (who will, as we have shown, be discouraged to monitor management in systems with overly costly and stringent disclosure and reporting rules and regulations), it is important for regulators to introduce a clear, but flexible, definition of (substantial) beneficial ownership. At the same time, this definition should allow for case-by-case determinations of beneficial ownership in order to enable regulators to include investors that use innovative financial instruments only with an eye to exert control over listed companies. Nevertheless, the design of a balanced and effective disclosure and reporting regime into a country's corporate governance framework poses something of a challenge to the extent to which the timing and disclosure of the stakes should be made and channels through which they should be made. Without a proportionate and flexible reporting and disclosure regime, it is unlikely that countries will be able to combine the best of two "worlds": protection against illicit related party transactions without creating disincentives for (outside) blockholders to monitor and discipline management.

We then asked that, given concentrated ownership, regulators should be concerned to stem the flow of illicit related party transactions. It was pointed out that, in some cases, related party transactions can play a positive role for firms. But to the extent that illicit related party transactions are detrimental to firm performance, we argued that they can be identified and prevented by a range of techniques. In this respect, the recently implemented audit regulations in the EU, which were designed to restore and enhance investor confidence through increased disclosure and transparency of related party transactions, are more likely to prove effective in preventing the recurrence of Enron and Parmalat style irregularities.

We further assessed the multilateral and domestic initiatives to combat the misuse of corporate vehicles for illicit purposes. There is clear evidence of an association between the ability to obscure the identity of the beneficial owners from the authorities and the use of legal entities to carry out illegal activities. The incidence of illegal activity carried out through legal entities suggests that this type of problem cannot be ignored and may require a comprehensive solution, which, as we have seen, may not rise immediately to the top of lawmakers' reform agendas.

To conclude, there is a wide range of options to obtain information about beneficial ownership and illicit, related party transactions. After reviewing the three most promising initiatives for obtaining extensive disclosure of beneficial owners, it can be argued that flexibility and proportionality must prevail in a country's disclosure and reporting regime. Firstly, a flexible regime, for instance, by offering "case-by-case" solutions, has the benefit of making the disclosure and reporting regime adaptable to technological and market changes. Secondly, and related to this, a flexible regime ensures that beneficial owners that use derivative arrangements to seek control over a listed company can be better targeted.